
10-2

Producer Subsidies and Decoupling in the European Union and the United States

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Executive Summary

Since 1986 agriculture has been a major part of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT), and since 1995 under the World Trade Organization (WTO). The main objective of these negotiations is to promote free trade through disciplinary rules and reduction of trade-distorting policies. The Uruguay Round Agreement on Agriculture (URAA) from 1993 established the current disciplinary framework for agricultural liberalization of domestic support, market access, and export competition.

Domestic agricultural support is considered trade distorting if it is coupled to production. The URAA introduced a reduction commitment of 20 percent on some types of coupled support. The reduction commitment was calculated on the basis of average support given in 1986–1988. Unfortunately, these years were peak years, when world market prices were low and therefore agricultural subsidies were high. Given that not all trade-distorting support was included in the commitment and that support in the reference period was already high, the domestic support reductions following the URAA have been disappointing and done little to open markets to more agricultural trade. The current WTO negotiations under the so-called Doha Development Agenda have not yet succeeded in pushing this agenda much further because major players like the European Union (EU) and the United States hesitate to make concessions. But such concessions are important for regaining momentum in the negotiations. Developing countries represented by Brazil, China, India, and Malaysia, among others, hold the entire negotiations in a deadlock while they wait for the EU and the United States to present proposals for serious liberalization of agriculture.

A point often ignored in the international trade debate is that agricultural policy is deeply integrated into the domestic policy-making process. Agricultural policy is founded on a long series of historical events and conditional economic and political structures and institutions, which vary across countries. Despite external reform pressure from GATT/WTO and bilateral trade partners and internal reform pressure from increasing budget costs, high levels of overall agricultural support persist in the EU and the United States. Even though reforms have occurred and support has

shifted toward decoupled, and hence non-trade-distorting, approaches, from a multilateral perspective these reforms are not enough. From a domestic perspective the results are more unclear. Overall, free trade improves the welfare of society, but some agents, like farmers and agribusinesses, also bear costs. These costs are large per agent compared with the average agent's gain. Together, these issues spill over into the policy-making process. At the end of the day, these costs create serious lobby pressure from farm interest groups, which make it difficult for the EU and the United States to promise serious liberalization of their agricultural protectionism.

Taking into account the relatively slow agricultural policy reform process in the EU and the United States, your assignment is to consider and reformulate the WTO legislation on domestic agricultural support. The proposal must be written in terms of both the overall WTO objective of trade liberalization and the domestic policy-making process.

Background

Introduction

Multilateral negotiations in the current Doha Development Agenda (DDA) under the WTO have run into serious problems. With the emphasis on development since the 2001 launch of the DDA, agriculture has been one of the most sensitive topics on the agenda. Developing countries, led by nations like Brazil, China, India, and Malaysia, have been persistent in calling for reduced agricultural protectionism in industrialized countries. For developing countries, agriculture is crucial for economic growth and development. Agricultural liberalization is therefore essential for the success of the multilateral approach.

Negotiations on agricultural trade liberalization fall into three categories: domestic support, market access, and export competition. Both market access and export competition are typical GATT/ WTO issues. Domestic agricultural support is a relatively new issue that has gained serious attention in recent years. In 2004 US\$279,527 million were spent on agricultural producer subsidies in the countries of the Organization for Economic Cooperation and Development (OECD). This amount

equals 30 percent of the total value of agricultural production in OECD countries (OECD 2006). Major players on the world market, like the EU and the United States, are giving substantial shares of this support to their farmers.

The decision to support agriculture is based mainly on domestic conditions. Domestic producer subsidies can, however, distort international markets when the subsidies influence farmers' choices of output and output level. Specifically, some types of subsidies give farmers an incentive to produce more than they would without subsidies. In this case, subsidies are said to be coupled to production—the more a farmer produces, the more support he or she receives. This kind of domestic support leads to increased agricultural production and accordingly an increased supply of agricultural products on both domestic and world markets. This overproduction places downward pressure on world market prices. Domestic support can thus be trade distorting and is therefore an issue for discussion in WTO negotiations.

Not all types of domestic subsidies are equally trade distorting. Decoupled subsidies tend to have a smaller effect on production levels and consequently on world market prices. An example of a decoupled subsidy would be a fixed yearly payment to the farmer, given regardless of what and how much he or she produces. A solution to the domestic support problem might therefore be to switch entirely to decoupled subsidies. It is not clear, however, whether this solution is politically feasible (and desirable). Many actors have a say in this issue, and many interests must be considered at both the domestic and the international level. This case study provides an analysis of this set of problems and the core stakeholders in the political decision-making process.

A Theoretical Perspective on Decoupling:

The Economic Rationale

Perceptions on the decoupling of agricultural subsidies are as varied as decoupling mechanisms. In order to discuss the economic rationale for decoupling, it is necessary to clarify the definition of decoupling in strict economic terms. Based on the work of Rausser and Foster (1987), Cahill (1997) was one of the first to provide a clear, simple definition: an agricultural subsidy is fully decoupled

if the payment does not influence the production decisions of farmers who receive payments and if the payment allows free market determination of prices. In other words, the subsidy must not change the demand and supply curves. The OECD (2001) operates with a looser definition of decoupling, called effective full decoupling, which is more applicable in practice. Effective full decoupling requires that the production level with support not be larger than the production level without support, as long as the market is in equilibrium. The response to exogenous shocks to the economy does not have to be identical to a zero subsidy response; hence the slope of the demand and supply curves can be different from a situation without subsidies.

From an economic point of view, effective full decoupling of subsidies is the ideal way to support agricultural production because such subsidies will not distort agricultural production and agricultural markets. As mentioned earlier, elimination of production distortions that come from domestic support gives equal terms of competition between countries on the world agricultural market.¹ In many developed countries, coupled agricultural subsidies elicit overproduction. Overproduction leads to excess supply on the world market and hence to downward pressure on the world market price. A low world market price creates a competitive disadvantage for countries that do not subsidize agricultural production, and the agricultural commodities will not necessarily be produced where the comparative advantage is the greatest.

Swinbank and Tranter (2004, 171) noted that the main economic benefit of decoupling in the European Union is that it "gives greater freedom to farm, thereby potentially reducing their [the farmers'] costs and increasing their profits. For the economy as a whole this means an increase in welfare, as agricultural output is produced at lower cost." This argument coincides with the previous ones but focuses on domestic considerations. Decoupling gives the single farmer the freedom to produce the commodities that are the most profitable in real terms and not in terms of which

¹ Leveling the playing field in principle includes eliminating tariff barriers and export subsidies. If these are not eliminated, one can say only that elimination of production distortions due to domestic support will give *more* equal terms of competition on the world market.

commodities are subsidized the most. When farm production follows patterns of comparative advantage, it is likely to reach the highest level of productivity at the lowest cost possible. This scenario is possible under a decoupled support regime, but it will not necessarily happen under a coupled support regime.

Whether a fully decoupled support instrument exists in practice is a point of discussion, for two reasons. First, decoupled agricultural subsidies have until now not been implemented as a sole instrument anywhere. In the EU and the United States, decoupled instruments have been introduced as a part of a policy package in combination with more coupled instruments. In such policy packages of coupled and decoupled policy instruments, it is difficult to identify influences attributed specifically to decoupled instruments, especially in instances where such instruments widen cross-commodity effects. As emphasized by OECD (2001) and Gohin et al. (2000), it is generally important to analyze the impact of a whole policy package and not just a single instrument.

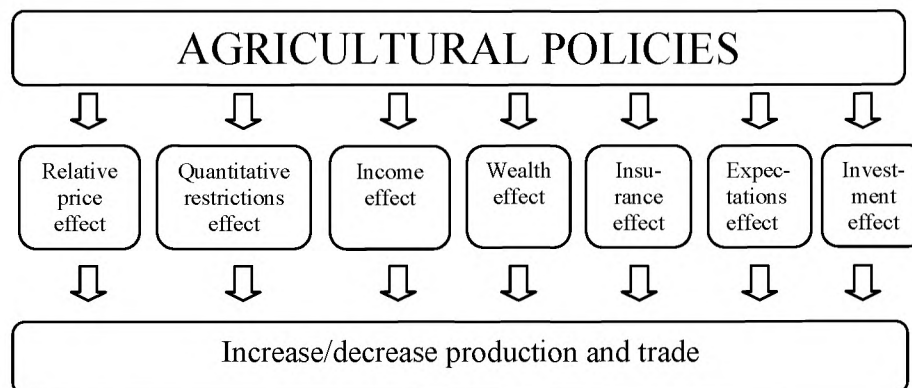
Even though most of the decoupled subsidies introduced so far would have no effect on production from a marginal optimization point of view, some additional effects can still potentially affect the supply response of the single farmer. These effects occur because of the farmers' attitudes toward risk, wealth, and investment and also the

farmers' expectations about future agricultural policies (OECD 2001).

These effects are outlined in Figure 1. The relative price effect, the quantitative restrictions effect, and the income effect can be analyzed in a static world (a world without time, risk, and uncertainty). If risk is included in the analysis, one can also observe wealth and insurance effects, and when time is introduced, one can analyze expectations and investment behavior in the long run. The workings of some effects are rather complicated, and note that the descriptions that follow here are simplified. Readers interested in more detail are referred to OECD (2001) and OECD (2005b).

The relative price effect works across different agricultural commodities. If one commodity is supported more than other commodities, the more-supported commodity's price is relatively higher than the prices of other commodities. This price difference can create a bias toward producing this commodity instead of other commodities. The relative price effect thereby indirectly reduces the production of commodities that are less supported (to the extent that they become relatively less profitable to produce). In principle, decoupled subsidies do not have any relative price effects because the farmer receives the subsidy regardless of what and how much is produced. If decoupling is not applied to all supported commodities, however, relative price effects can still exist.

Figure 1: Coupling Effects



Source: Inspired by OECD 2001.

If agricultural support programs put quantitative restrictions on output or input use, these restrictions directly affect the level of production. Examples of such restrictions could be milk quotas and land set-aside requirements. Restrictions have often been used to reduce the effect of increased production created by coupled subsidies.

The income effect basically shows that farmers' income level influences their choice of production level. If agricultural markets work perfectly and farmers are rational, they will produce the output that maximizes profits. Coupled subsidies marginally affect farm profits, and farmers will choose to produce more than without the subsidies. Decoupled subsidies do not affect farmers' profits marginally and therefore do not affect production size. In practice, however, the agricultural labor market and the market for agricultural production factors often do not work perfectly. In these cases increased income from decoupled subsidies tends to keep farmers and production factors employed above optimal levels.

Increased income from decoupled subsidies also increases farmers' wealth. In a world of risk and uncertainty, this result potentially creates a wealth effect. Most farmers are risk averse, and several studies show that farmers often have decreasing absolute risk aversion (DARA). DARA implies that richer farmers tend to accept more risk and to produce more than less wealthy farmers (Hennessy 1998). Therefore the wealth effect reflects the change in production elicited by subsidy-augmented wealth. Decoupled subsidies have wealth effects as well.

The insurance effect arises from the influence of agricultural subsidies on the risk level associated with agricultural production. Most agricultural subsidies stabilize or secure a certain level of agricultural income to reduce the risk of production (Hennessy 1998). Subsidies that stabilize income (such as disaster payments) generate the largest insurance effect. Since most decoupled subsidies only ensure higher income levels without stabilizing such income, the subsidy-induced insurance effects are limited (OECD 2005a).

An expectations effect plays a role in the long run. Farmers' expectations of future agricultural support

can affect their production decisions. A farmer who receives decoupled payments and expects that these same payments will continue for the next 10 years will think and act differently from a farmer who expects a reduction of the decoupled subsidies over the same period. Expectations are difficult to measure empirically, and hence the literature lacks estimates of these effects (OECD 2004b).

Lastly, an investment effect exists to the extent that higher income, due to agricultural subsidies, leads to larger investments in agricultural production factors and in turn elicits higher agricultural production. Whether or not the investment decision is affected by agricultural subsidies depends on whether the amount of agricultural subsidies received changes owing to the investment. If farmers receive decoupled subsidies, their investment decisions will not be affected unless some of the previously mentioned effects would also lead to increased investments. If farmers borrow money to make investments, their receipt of agricultural subsidies also enhances their credit ratings (OECD 2005a).

Researchers have thoroughly investigated some of the coupling effects using different modeling approaches, and also more empirically in the case of the United States. Because of lack of adequate data on the implementation of the 2003 reform of the EU's Common Agricultural Policy (CAP), empirical estimates from the EU vary in magnitude and quality, giving ambiguous results for the effects of decoupled support. Even though some production effects are likely unavoidable, decoupled support instruments do appear, however, to generate milder effects than coupled instruments.

Following Cahill (1997), researchers started to measure the production effect of support instruments by the degree of decoupling. Degree of decoupling relies on the assumption that a support instrument is fully coupled to production (gives the maximum production effect) if it consists of price support, and it is fully decoupled if it has zero effect on production. On an index ranging between zero and one, a degree of decoupling of zero indicates a fully coupled subsidy and a degree of one indicates an effective fully decoupled subsidy. The degree of decoupling can be derived by dividing the production effect of the support instrument

$\Delta Q(\text{subsidy})$ by the production effect of an equivalent price increase $\Delta Q(\text{price})$ and subtracting it from one [OECD 2001].

$$\text{Degree of decoupling} = 1 - \frac{\Delta Q(\text{subsidy})}{\Delta Q(\text{price})}$$

The degree of decoupling can exceed unity, suggesting a negative subsidy-induced production effect. It is a rather simplified way of measuring the degree of decoupling since measuring the degree of decoupling for single instruments is questionable. As noted earlier, the effect of a whole policy package is important and far more complicated.

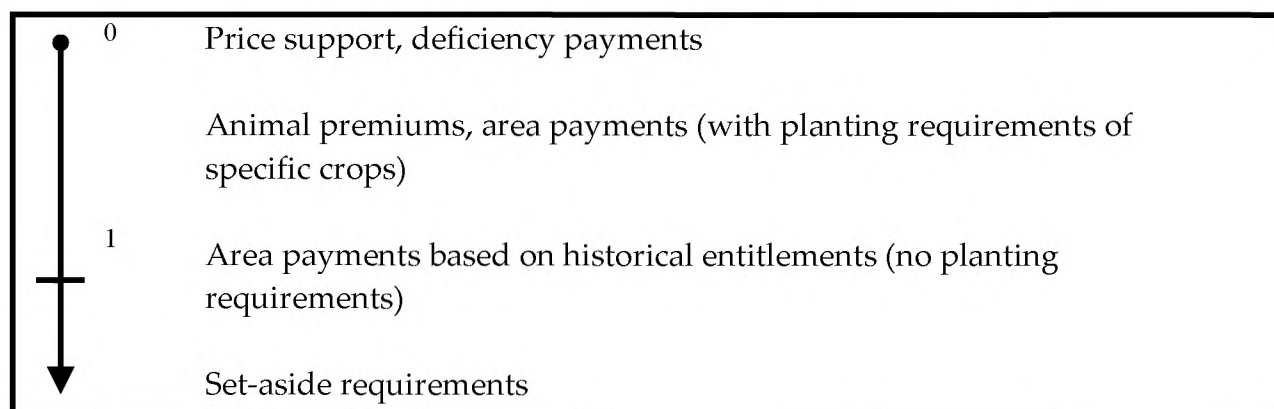
Some of the subsidies used in the EU and the United States can be placed on the degree of decoupling scale approximately as shown in Figure 2.

Set-aside requirements are not agricultural subsidies, but they are worth mentioning because they are often closely linked to agricultural subsidies. Introduced separately, they are likely to elicit a negative production impact. Likewise, subsidizing one commodity can have a negative production effect on other commodities (cross-commodity effect) [OECD 2003]. Area payments based on historical entitlements are the type of payments introduced with the Single Payment Scheme in EU,

which is described later. Because these payments are broadly defined as decoupled payments, they are currently permitted by the WTO. Animal premiums and area payments with planting requirements are generally considered partially decoupled subsidies. They are not completely independent of production level because the payments are on a per planted hectare basis. They are also, however, not completely dependent on production levels because farmers will achieve no gain in subsidies by maximizing yields. Price support is generally considered the most coupled agricultural subsidy because the farmer is subsidized for the entire amount of the commodity produced through a higher price. Price support tends to induce overproduction because higher production generates larger subsidy payments. The same mechanism exists with the U.S. deficiency payments.

When agricultural subsidies are decoupled, the distortions and inefficiencies in producer and consumer markets are eliminated—this is the economic rationale for decoupling. It is probably not possible, however, to construct the ideal decoupled subsidy in reality because a range of coupling effects tend to influence farmers' choice of production. Yet decoupled subsidies have a much smaller production impact than more coupled subsidies, and from an economic point of view, decoupled subsidies appear preferable.

Figure 2: Different Agricultural Subsidies Placed Loosely on a Degree of Decoupling Scale



Source: Based on authors' evaluation of OECD 2001.

Producer Subsidies and Decoupling in the European Union

For many years, the core element of the CAP has been price support. To secure food supplies and farm income, a customs union was created in the late 1950s to facilitate free agricultural trade between the member states. All products were governed by individual market organizations with a set of institutional prices and an intervention mechanism that secured an artificially high European market price. As already described, price support generates a zero-value degree of decoupling and is therefore potentially very production distorting and trade distorting.

During the 1970s and 1980s, increasing problems occurred. The EU budget swelled as high prices led to overproduction. Budget outlays went to market intervention and export subsidies. During the 1980s the EU tried several steps to limit overproduction, such as by introducing quotas on milk and sugar. Overall overproduction continued, however, and pressure to reform the CAP emerged both from inside the EU and from the outside world in the GATT trade liberalization negotiations.

This internal and external pressure to reform the CAP also brought about the conclusion of the MacSharry Reform in 1992. The reform reduced price support to a wide range of agricultural products. As a compensation for the lower prices, hectare and animal premiums were introduced. Hectare premiums were paid for agricultural land planted to certain crops. They vary each year according to the size of the subsidy-entitled land. The hectare premium is not directly coupled to the level of production, but it can only be paid to land that is under cultivation. In the late 1990s the MacSharry Reform was deepened with the Agenda 2000 Reform (European Commission 1999). Price support was further reduced, and producers were compensated with a rise in the size of hectare and animal premiums. On a degree of decoupling scale, the support that was converted to hectare and animal premiums has a higher degree of decoupling than does price support and should therefore be less production and trade distorting.

Current WTO negotiations began in 2001, and a future agreement will potentially put new demands on domestic support. Also the expansion of the EU from 15 to 25 countries increased internal EU demands to rethink the CAP. In 2002 Agricultural

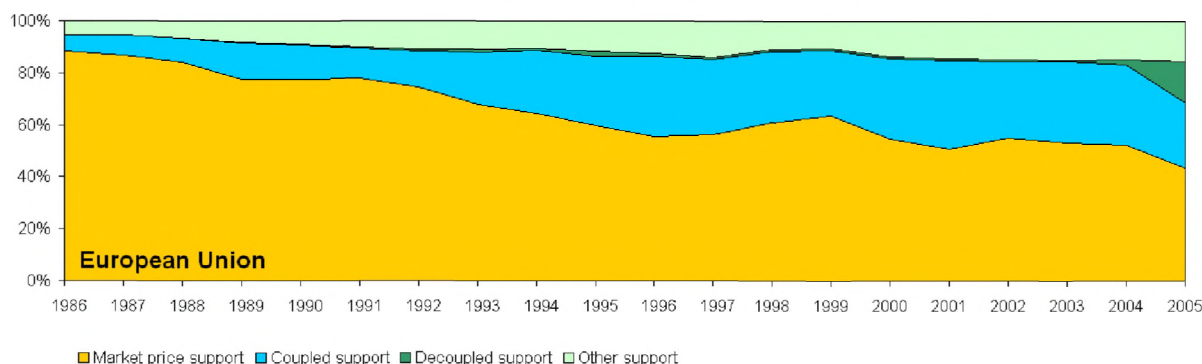
Commissioner Franz Fischler revealed an entirely new CAP reform proposal as a part of the midterm review of Agenda 2000. Even though some member countries were highly critical of the proposal, in July 2003 they agreed on a compromise, which was implemented in January 2005 (Council Regulation (EC) no. 1782/2003).² Part of EU agricultural support is now given as a decoupled subsidy called the Single Payment Scheme. The Single Payment Scheme broadly covers cereals, durum wheat, rice, potato starch, dried fodder, and cattle. Since 2005, reforms of EU sugar and oilseed policy have followed the same line of change.

The Single Payment Scheme sets farmer subsidies at the same amount annually regardless of production. The decoupled payments require that farmers comply with a range of requirements on good agricultural and environmental conditions and other statutory management requirements. Collectively, these requirements are called Cross Compliance. The implementation of the Single Payment Scheme varies noticeably across the member countries, because different implementation options were possible. Therefore the CAP has become far more complex than previously.

Figure 3 illustrates the composition of EU support from 1986 to 2005. Price support clearly dominated until the MacSharry Reform in 1992. Thereafter other coupled subsidies, specifically hectare and animal premiums, gradually increased, and by 2005 a noticeable share of these subsidies were converted to decoupled support under the Single Payment Scheme. Results of the sugar reform are not discernible until 2006, and in some countries the Single Payment Scheme has not been fully implemented yet. Figure 3 shows that although the latest CAP reform introduced substantial changes, coupled subsidies and price support continue to make up the principle component of EU farm subsidies. Only part of the support has been changed to less distorting forms.

² Council Regulation (EC) no. 1782/2003 of September 29, 2003, established common rules for direct support schemes under the Common Agricultural Policy, established certain support schemes for farmers, and amended regulations.

Figure 3: Composition of Support Given to EU Agricultural Producers, 1986–2005



Source: OECD 2006.

Note: The categories of support are from the standard OECD producer support estimate categories as follows: Market price support = market price support. Coupled support = payments based on output + payments based on area planted. Decoupled support = payments based on historical entitlements.

Other support = payments based on input use + payments based on input constraints + payments based on overall farming income + miscellaneous payments. The category “other support” contains much support given on environmental and other objectives, and the coupling effect of these subsidies is not always clear.

The EU is still far from having a completely decoupled farm subsidy scenario. On the other hand, the agricultural policy changes so far are in line with WTO requirements for domestic support. Price support has been reduced, and most of the hectare and animal premiums have been changed into decoupled payments, which are allowed under the WTO (Jensen and Zobbe 2006).

Producer Subsidies and Decoupling in the United States

Since the first farm support program in 1933, the overall objective of government intervention in agriculture has been income protection for U.S. farmers. Current agricultural policy in the United States is governed by the Farm Security and Rural Investment Act of 2002. Three of the 2002 Farm Bill’s instruments relate to commodity subsidies: loan rate programs, decoupled direct payments, and countercyclical payments. The most commonly used type of loan rate is the loan deficiency payment, which is a product-specific minimum price that will secure farmers’ income in case of collapsing world market prices. The loan rate size is

governed by provisions in the 2002 Farm Bill. If the loan rate is higher than the world market price, the farmer will be compensated for his loss. The decoupled direct payment is a non-product-specific payment to each farmer every year based on historical production and income. The central mechanism in the countercyclical payments is the target price. This price is fixed in the legislation, and it constitutes a desirable level of income. The government pays the producer the difference between the target price and the higher of the 12-month-average market price or the loan rate plus the per-unit direct payment. This countercyclical payment is non-product-specific and based on historical production data (Knutson et al. 2004). To sum up, in a good year farmers receive only direct payments, and in a bad year they can receive all three types of support.

The current 2002 Farm Bill has evolved from an array of successive farm bills. Historically, U.S. farm policy has gone through three phases. First, full-scale government intervention in agriculture was introduced as a major part of the New Deal legislation stemming from the farm crisis of the 1920s

and early 1930s, when farm prices and income fell relative to nonfarm prices and income. The policy mix introduced through the Agricultural Adjustment Act of 1933 included supply controls combined with price support, loan rate programs, and direct payments. Because of the very detailed supply control, a nationwide administration was set up to enforce and control the legislation.

Second, following a social welfare debate in the 1960s, the composition of large shares of producer support changed radically from price support to deficiency payments. This change became manifested in the 1973 Farm Bill. The debate in the 1960s had dealt with two issues. One problem was the lack of flexibility in the support system. The traditional fixed price support failed to reflect changes in world market prices, and in turn implied unchanged consumption levels. The other issue related to a social-ethical problem: because poor consumers spend relatively more of their income on food than wealthy consumers do, they are more affected by the burdens of price support.

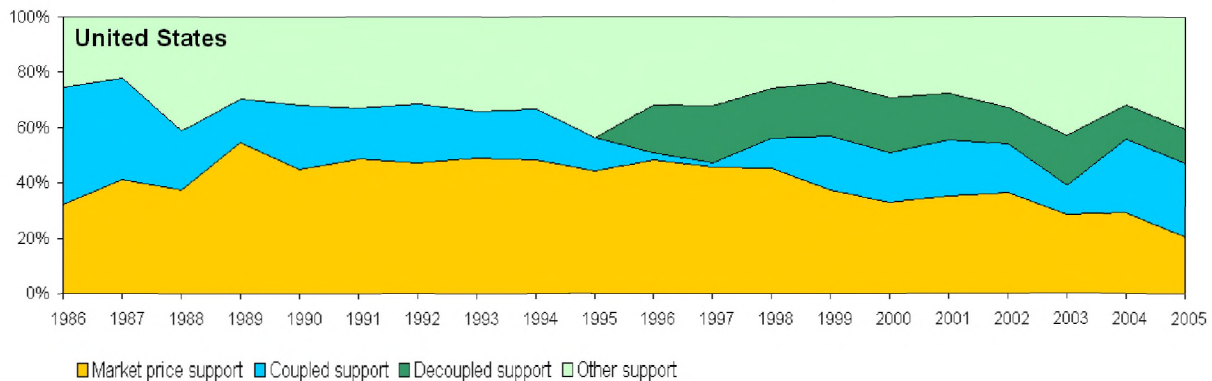
The third phase is the fundamental shift in the philosophy of agricultural intervention that took place in 1996. The 1996 Farm Bill, titled the Federal Agriculture Improvement and Reform Act, abolished supply controls, decreased the loan rates, and moved the bulk of producer support from deficiency payments to decoupled direct payments.

Decoupling is not a new issue in farm policy in the United States. The concept of coupled and decoupled support was discussed surrounding the Agricultural Adjustment Act of 1933 (Nourse et al. 1937). Furthermore, decoupling was a subject of debate in discussions surrounding the 1947, 1973, and 1985 farm bills, but at the end of the day, the political will to decouple support was not there. In 1996 the Congress and the Clinton Administration did what previous sessions could not agree upon. The traditional coupled deficiency payments were changed into decoupled payments based on historical data on production and income.

To examine this change, it is important to look at the political system. Historically, political ideology and economic principles have tended to collide. Since President Franklin D. Roosevelt launched the New Deal in 1933, the Democrats have generally favored supply control and tended to promote coupled support. The Republicans, on the other hand, never really liked the idea of a state agency that controlled overall farm production. This is by no means to say that Republicans are against farm support, but they tend to favor more decoupled policy instruments that allow the market to play a larger role in agricultural production. According to Paarlberg and Orden (1996), the midterm election of 1994 explains a major part of the policy change in 1996. In that election the Republicans gained control of both chambers in Congress. Until then, the Democrats had controlled at least one of the two chambers since 1955. This new situation, together with a globalization-friendly president in the White House and high commodity prices, helped pave the way for the 1996 Farm Bill.

The current 2002 Farm Bill succeeded the 1996 Farm Bill and must be evaluated as an adjustment of the previous act. With regard to decoupling, one issue in the 2002 Farm Bill has overshadowed other issues. The 2002 legislation allowed farmers to update their area base data stated in the 1996 legislation. This provision was problematic because it creates a link between current production and future producer subsidies, hence coupling support and production decisions. The reason for this provision lies in biotechnical research. New research had extended the growing area for corn and soybeans north to North and South Dakota, where decoupled payments were being calculated based on their historical grain crops. Allowing the farmers to update their base data was seen as a way of securing a fair distribution of support between all U.S. farmers. The composition of U.S. support from 1986 to 2005 is shown in Figure 4. The bulk of support is still given as coupled support, and in fact only a fraction is decoupled.

Figure 4: Composition of Support Given to U.S. Agricultural Producers, 1986–2005



Source: OECD 2006.

Note: The categories of support are from the standard OECD PSE categories as follows: Market price support = market price support. Coupled support = payments based on output + payments based on area planted – disaster payments. Decoupled support = payments based on historical entitlements. Other support = payments based on input use + payments based on input constraints + payments based on overall farming income + miscellaneous payments. The category “other support” contains much support given for environmental and other objectives, and the coupling effect of these subsidies is not always clear.

Policy Issues

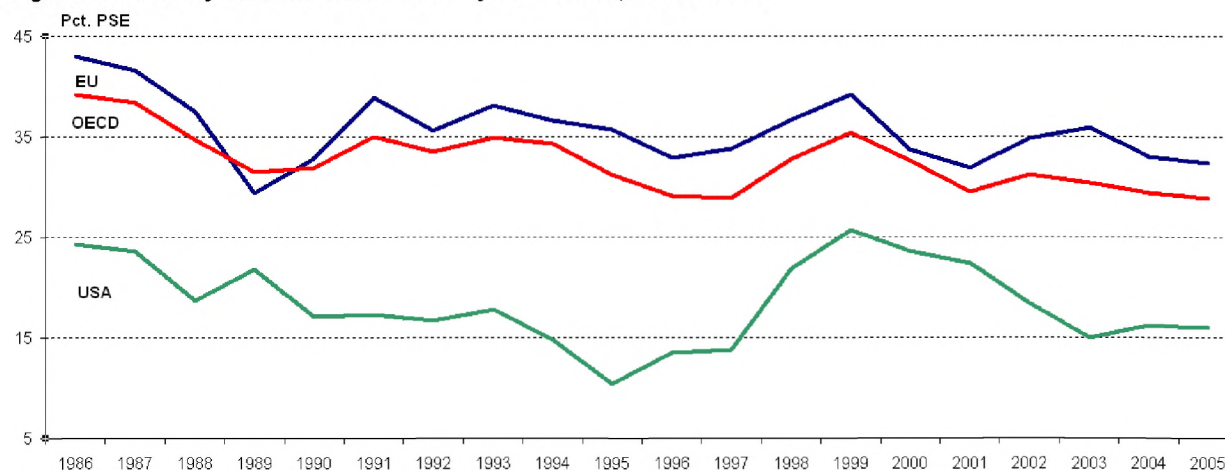
From an overall welfare economic point of view, the first best solution would be to restrict the government’s role in agriculture to correcting market failures. This approach would secure the most optimal allocation of the factors of production. If government, for some reason, is unsatisfied with the income distribution generated through the marketplace and wants to redistribute income to the farmers, the first best solution would be cost-free lump-sum transfers. In effect this solution would mean historically based, decoupled payments with minimal influence on production and hence trade. In practice the international and domestic discussion on agricultural subsidies is more complicated, and the economic agenda is difficult to adopt.

International Policy Issues

The international focus on agricultural subsidies dates back to 1982, when the OECD adopted the

so-called trade mandate. The aim was to analyze the possibilities for gradually reducing agricultural protectionism and for including agriculture in the multilateral trade system. A framework was established to analyze agricultural policy and the impact on international trade. In 1986 the OECD began to measure agricultural support in member countries. The measure used is called producer support estimate (PSE) and is basically a monetary estimate for the support transferred to producers. Figure 5 reports PSE as a percentage of the value of agricultural production for the European Union, the United States, and the OECD. After years of work, the OECD report *National Policies and Agricultural Trade* was released in 1987. It served as a key input to the Uruguay Round negotiations (1986–1993) under GATT (Coleman and Chiasson 2002). This was the beginning of a new agenda in international agricultural policy and of an institutional development whose effects we still observe today.

Figure 5: Share of PSEs in Total Value of Production, 1986–2005



Source: OECD 2006.

The URAA established the disciplinary framework for domestic agricultural support in GATT/WTO member countries by categorizing support into three boxes: an amber box with trade-distorting support; a blue box with production-coupled support combined with production-constraining programs; and a green box with decoupled support programs. The URAA introduced reduction commitments on the amount of domestic support allowed in the amber box, while assistance in the blue and green boxes was exempt from reduction commitments. In the amber box, an aggregate measurement of support (AMS) was defined as an indicator of the amount of trade-distorting support. The developed countries agreed on a 20 percent reduction commitment on the total AMS (and the developing countries agreed on 13 percent) in the URAA from an initial historical base of domestic support. The reduction commitments on the most distorting subsidies in the amber box have, so far, not been so tight that any member country has reached the binding limit. In principle, all production-coupled support should have been cut, but because of the exemption of the blue box and a historical base period reflecting high initial support levels, cuts to domestic support following the URAA have been rather disappointing.

Green box subsidies are defined in the WTO context as decoupled subsidies. They are considered to be minimally production- and trade-distorting, and these policies are generally permitted. The WTO guidelines for classifying policies into the green box

concern primarily policy design rather than directly specifying the level of production and trade distortion allowed (Frandsen et al. 2002). The definition listed in Annex 2, Article 5 of the URAA is as follows:

Decoupled income support

- (a) Eligibility for such payments shall be determined by clearly defined criteria such as income, status as a producer or landowner, factor use, or production level in a defined and fixed base period.
- (b) The amount of such payments in any given year shall not be related to, or based on, the type or volume of production (including livestock units) undertaken by the producer in any year after the base period.
- (c) The amount of such payments in any given year shall not be related to, or based on, the prices, domestic or international, applying to any production undertaken in any year after the base period.
- (d) The amount of such payments in any given year shall not be related to, or based on, the factors of production employed in any year after the base period.

- (e) No production shall be required in order to receive such payments.

The policy design requirements only allow subsidy types with very modest effects on production and trade. There will be no direct link between support and production size, and these types of subsidies will typically be in the high end of the degree of decoupling scale. In both the EU and the United States, substantial changes in agricultural policy have taken place since the conclusion of the URAA. One of the drivers of these reforms has been the international debate on liberalizing world trade.

Domestic Policy Issues

Arguments for decoupling producer subsidies are more straightforward in an international context than in a domestic one. In many OECD countries, including the EU and the United States, agricultural policy is part of domestic redistributive economic policy. Historically, agricultural support was undertaken because of the so-called farm income problem, which states that farm income is more unstable and decreases relative to nonfarm income over time (Gardner 1992). Today the rationale for the subsidies is far more blurred. It is probably a combination of the farm income problem and a fear of what would happen if the subsidies were truly decoupled or removed. Decoupling could result in financial stress partly because the subsidies have been capitalized in the land values and the values of other production factors and partly because it could potentially lead to large changes in the location of agricultural production through a market-based specialization and division of labor.

From a government point of view three issues are of concern when agricultural policy issues are dealt with. After a decision to support farmers' income is made, the first issue is the choice of policy instrument. Although various instruments can be chosen, we focus on three: price support, deficiency payments, and direct decoupled payments. Each instrument has various characteristics and efficiency levels. Their only common characteristic is that they transfer money from society to farmers. The transfer efficiency is determined by transfer loss such as distortion costs and transaction costs (OECD 1995).

Price support is mainly paid by the consumers through an artificially high price. This high price provides support for the farmers and gives them incentives to increase production. To be effective, price support is often combined with an intervention mechanism to stabilize the price and with tariffs to protect domestic farmers from world market competition. If a country is a net importer, this approach results in national tariff revenue, and if the country is a net exporter, it results in export subsidies paid by the taxpayers. Administratively, a price support is easy and cheap to operate because it can be managed through the food-processing industry.

Deficiency payments are paid by taxpayers. The farmers plan their production on the basis of a politically defined target price. This higher price gives farmers an incentive to increase production. If the country is a net exporter, the deficiency payment in principle works as an open-ended export subsidy as well. The operation of a deficiency payment scheme depends heavily on administrative control. Every farmer needs to be taken into account because the level of support depends on the actual harvest, and this implies high administrative costs.

In theory, direct decoupled payments have no influence on production. Direct decoupled payments are taxpayer financed, but because of the nature of direct decoupled payments, the cost of administering such a scheme is smaller than for the deficiency payments. Once direct decoupled payments are calculated, the same amount of support is paid to each farmer annually.

The initial choice of policy instrument or policy mix is fundamental in the long run because history has shown that in this area there is a high degree of path dependency. The choice is based on issues like the objective of the policy, administration skills, ideology, structure of the agricultural sector, and openness of the economy.

When producer subsidies are implemented, everything is not equal. After the choice of policy instrument, the second relevant issue is the trade-off between farm support policy and other economic policies. The most obvious is fiscal policy because of the costs of subsidies. If farm subsidies increase there are two approaches to cost: the

budget can be increased, or other costs can be decreased. Agricultural policy also spills over into other policy areas, which must be considered. These areas include rural development policy, environmental policy, labor policy, tax policy, social policy, foreign policy, aid policy, and trade policy. How these areas are handled comes down to governments' preferences about which policy areas should have the greatest weight. In both the EU and the United States, agricultural producer subsidies appear to be ranked extremely high.

The third and likely the most important issue concerns navigating the unstable waters of the political decision-making process. U.S. agricultural policy evolves from a consensus between the White House and Congress. Traditionally Congress (the Senate and the House of Representatives) have had the initiative in this matter. In the United States there also exists a very tight relationship between the civil servants in the U.S. Department of Agriculture (USDA), the politicians in the two congressional committees on agriculture, and the leaders of the national farm organizations. This relationship is often referred to as the "Iron Triangle" and can be found in many nonfarm policy areas as well. In farm policy, this triangle is influential for two reasons. The practice of electing two senators from each state grants a relatively high degree of political power to the agricultural states of the Midwest and the South. The result is a powerful Senate agricultural committee whose influence goes far beyond farm policy. The other reason for the successful Iron Triangle is related to the historical ties between the USDA and the agricultural sector, which go back to the 1860s. The New Deal and the creation of the Agricultural Adjustment Administration in 1933 strengthened these ties even more through the build-up of local branches across rural America. The details of supply control administration ensured a tight relationship between farmers and civil servants.

In the EU, agricultural policy is made through a complicated decision-making system that consists of the Council of Ministers, the European Commission, the European Parliament, and various interest groups. The Council of Agricultural Ministers deals with the Common Agricultural Policy (CAP). All member countries are represented on the council, and their attitudes toward the CAP reflect national interests. Behind every minister there exists a

sovereign country with a separate political decision-making system. Because of the CAP's status as a supranational policy, there is a voting procedure that both respects the rights of the majority and protects the rights of the minority. The Council of Agricultural Ministers, however, has traditionally stressed consensus. The European Commission is the government of Europe, and on CAP issues it has the initiative. In practice, this means that the Commissioner of Agriculture prepares and presents proposals for the Council. If the Council opposes a proposal, it is up to the commissioner to navigate and repropose. The role of the European Parliament with regard to CAP is to either adopt or reject the total budget for the European Union.

Historically the farmers of Europe have had a great interest in the CAP and have exercised their interests through COPA (Committee of Professional Agricultural Organisations in the European Union), an organization made up of representatives of national farm organizations in the EU. COPA has both formal and informal influence on the decision-making process. Over the years, other interest groups in the areas of consumer rights, environmental protection, and developing countries' rights also have shown interest in the CAP. Besides lobbying on a European level, farm and other groups also lobby on the member state level. The influence of the farm lobby on politicians varies across countries, but in member states like France, Greece, and Poland, among others, governments are highly influenced by farm conservatism, which of course spills over into European decision making.

Stakeholders

Many groups and institutions have interests in EU and U.S. domestic support policies. These interests vary widely and add to the complexity of domestic support policies. Trade partners can be divided into two groups—those who benefit and those who lose from EU and U.S. domestic support. Agricultural exporters like Australia and New Zealand have an interest in promoting support policies that do not distort trade. The fact that coupled agricultural subsidies create overproduction followed by excess world supply, lower world market prices, and lower import demand affects exporting countries negatively. Some developing countries, especially least-developed countries like those in Sub-Saharan Africa, have preferential access to the European

and American markets. One example is the Everything but Arms (EBA) initiative launched by the EU. This initiative gives least-developed countries (LDCs) tariff- and quota-free access to high-price European markets with exceptions for a few goods.

The reduction of price support results in preference erosion for the LDCs with preferential access to European and U.S. markets. Countries with such preferences are therefore interested in keeping the status quo rather than changing the agricultural subsidies into less-distorting forms with no price effect on agricultural products.

As an international organization that works toward liberalizing world trade, the WTO is also a stakeholder in the issue of domestic agricultural support policies and their effects on world trade. Different interests are at stake on the international scene, and an unambiguous solution to the domestic support issue is not easy to find.

Domestically, price support is financed by consumers and taxpayers. The former group pays a higher price for agricultural products, and the latter group pays for price-supporting facilities like intervention mechanisms and export subsidies. Both coupled and decoupled direct support are financed by taxpayers. In the case of a large economy, deficiency payments can benefit the consumer because overproduction depresses prices on the world market. These groups of consumers and taxpayers are very heterogeneous. The amount of money transferred to farmers from a single consumer or taxpayer is relatively marginal. Many consumers are not aware that they support farmers through food prices. Therefore substantial consumer opposition to agricultural subsidies is relatively unlikely. Consumer interest groups exist, but they are most often focused on other specific issues like food safety and environment.

The farm interest groups have much stronger interests at stake, both nationally and internationally. The degree of influence that farm lobbies exercise on farm policy formation varies across countries. Farmers often view decoupled payments as social welfare payments to which they are generally averse. Farmers are also aware that direct subsidies are much more visible to the public. Whereas consumers may hardly notice higher food prices, direct subsidies are much easier to quantify when

they are visible as huge expenses on the common European Union budget and on the federal budget of the United States. This visibility makes it easier for both politicians and interest groups to target them and demand reductions. Farm interest groups often receive support in lobbying for coupled support by the upstream and downstream industries. The capitalization effects of support also affect agribusiness, and future liberalization of support could create financial stress in the short run and change demand and supply in the primary sector in the long run through serious structural adjustments.

As already mentioned, an increasing number of other interest groups are showing an interest in agricultural policy. Among these are environmental groups seeking to reduce agriculture's negative influence on environment, animal welfare groups focusing on agriculture's intensive use of animals, and groups focusing on rural development and on growth and rights of developing countries. All these groups have many issues at stake regarding agricultural policies and agricultural subsidies, complicating the process of reforming agricultural policies in the EU and the United States. A change toward using more decoupled subsidies is not as simple as it seems in theory.

Policy Options

Since the 1982 implementation of the OECD Trade Mandate and the inclusion of agriculture in multilateral trade negotiations in 1986, report after report has shown that liberalization of domestic agricultural policy, hence producer subsidies, should be a part of the solution. Under both the Uruguay Round (1986–1993) and the Doha Development Round (2001–?), discussions about disciplining and reducing domestic support have gained much attention in the international debate. Despite this attention from economists, politicians, and the media, the actual results are rather disappointing, as shown in Figures 3, 4, and 5. Some changes have occurred in the composition of the support, but a radical shift toward decoupled support is not discernible.

This slow progress despite the attention indicates a problem in multilateral trade negotiations. Four policy options can be identified. First, abolishing the consensus rule in WTO could change the

dynamics of the negotiations and make reaching an agreement easier. Second, instead of centering on broad rounds, negotiations could focus on specific issues to be agreed upon separately. Sensitive issues could thus be avoided. Third, agreeing on the status quo would mean that there will be no more negotiations on domestic support. The Uruguay Round Agreement on Agriculture would then stand as permanent legislation. Fourth, instead of following the old agenda on domestic support in the WTO, a new one could be developed. These four policy options will be explored in more detail.

The first two options both relate to the organization of the WTO. The benefit of changing the consensus rule to some kind of voting procedure would be to abolish the de facto veto right of all member states. This approach would change the dynamics of negotiations because countries with inflexible positions on, for instance, domestic agricultural support, would lose influence. One of the problems would be to design a voting procedure. How would the weight attached to each country be decided? Should it be based on geographical size, population, GDP size, or trade volume, and what about the balance between developed countries and developing countries? Another even more serious problem could be that countries would leave the WTO for fear of losing control and sovereignty. Such an outcome could jeopardize all that both the GATT and WTO have achieved over the years.

The benefit of moving away from the concept of broad rounds of negotiation would be to concentrate all the administrative and technical expertise of the WTO and the member states on one issue at the time. A working agenda like this would allow the WTO to step out from the shadows of GATT and unfold its potential as an organization. A problem with this approach is that the whole idea of broad rounds allows for winners and losers for each topic discussed. The negotiation of many different topics at the same time increases the possibilities for trade-offs, and hence for reaching an agreement. The more fundamental problem with these first two policy options is that they will change the spirit and the overall atmosphere of the multilateral trade negotiations that have developed since 1948.

The third policy option is to abolish the negotiations on domestic agricultural support. The URAA

would then stand as permanent legislation. The benefit of doing so would be to cut off negotiations on a politically sensitive area where progress is limited. Additionally, it would move focus to the other two areas of agricultural negotiation under the WTO: market access and export competition. According to a study by Anderson and Martin (2006), the potential benefits of trade liberalization in agriculture will come mainly through increased market access. This finding supports a shift in focus from domestic subsidies to market access. There are at least three problems with this policy option. First, the area of market access is by far the most sensitive area in agricultural negotiations, and at the end of the day a trade-promoting agreement would still be far away. Second, it is no coincidence that the negotiations on agriculture are divided into domestic support, market access, and export competition. The three areas are deeply linked. For example, domestic price support needs to be combined with strict border controls to be effective. Third, the URAA is far from a perfect agreement. One of its problems is that allowed producer subsidies are based on the average support given in 1986–1988, a period when the world market price was seriously depressed and consequently tariffs and agricultural subsidies were high. As a result, members like the European Union and the United States are left with rather flexible support commitments.

The discussion of the first three policy options leads to the fourth one. Domestic support is an important area of discussion in the WTO, but the slow progress in current negotiations indicates the need for an adjustment of the agenda set by the URAA. This adjustment should incorporate existing knowledge from the URAA, knowledge about coupling and decoupling support on both a theoretical and a practical level, and knowledge about the domestic policy-making process.

Assignment

Taking into account the relatively slow agricultural policy reform progress in the European Union and the United States, your assignment is to consider and reformulate WTO legislation on domestic agricultural support. The proposal must be written in terms of both the overall WTO objective of trade liberalization and the domestic policy-making process.

Additional Readings

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